RICHARD RUSSELL'S **DOW THEORY LETTERS, INC.**

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MIX: The subscription "mix" of these reports has been changing rather dramatically over the past few years. For one thing, I note that our foreign subscriptions have been steadily increasing. I don't know whether this means that foreigners are taking an increasing interest (or own an increasing interest) in the US, or whether it means that more and more US citizens are moving out of the country. I suspect it means *both*.

I also note that our subscription list is now dotted with corporate names, in a manner that I have not seen before. What do the chairmen of the boards and presidents and treasurers of some of the largest corporations in the nation want with an independent advisory service? My guess here is that they are beginning to distrust their own well-staffed economics departments and their highly-paid, conventional-minded economic consultants. Corporate leaders did not get where they are by reading the consensus opinions and the "safe and sane" reports. They got there by thinking ahead of the pack, and these gentlemen in increasing numbers are now (I suspect) beginning to MISTRUST their regular lines of information.

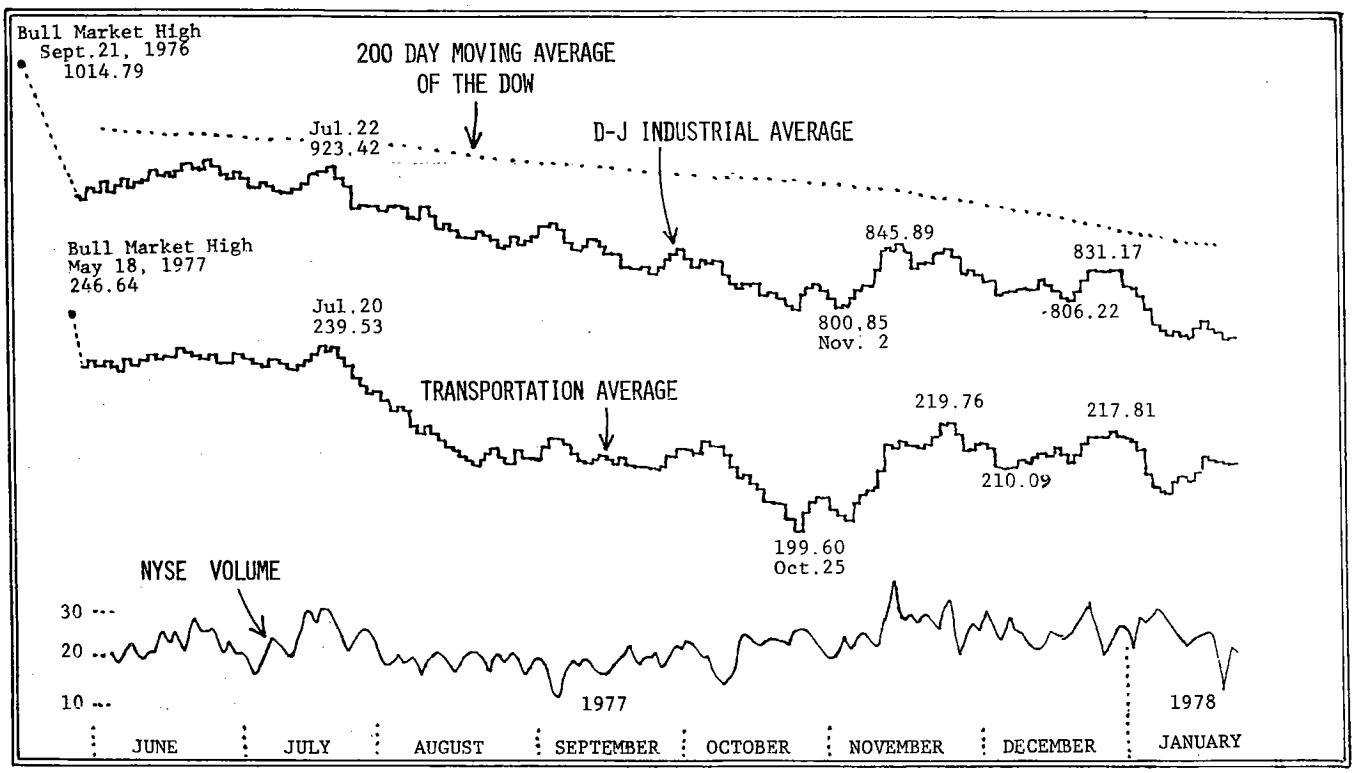
That's fine with me, because I distrust the same standard opinions and statistics. And I've noted that most of the famous and widely-quoted crystal ball gazers usually end up eating broken glass. As far as I'm concerned, **the true story is in the markets**, and I'm talking about the stock markets of the US and the world , the bond markets and the commodity markets. If any of us were smart enough to be able to extract 10% of the knowledge and information contained in the markets, we could probably run the world (and own it as well). But it's only given to us mortals to know a small part of what fate has in store for us. Personally, I spend half my waking hours pondering my squiggles and charts and data, trying to come up with something that makes sense. So far, I've been lucky enough to be more right than wrong, which is not too bad in this very difficult business.

MARKETS: Question: Russell, what are you looking for—at this juncture?

Answer: I'm watching the most *persistent trends* in my various indicators, on the principle that "the strongest man and the most persistent man will always overcome the weaker man." At this point, it seems to me that the strongest trends are seen in the declining trend in the D-J Industrial Average, the declining trend in the Utility Average and the declining trend in the various bond averages. The indicator most resistant to decline (as it has been for 16 months) is still the Transportation Average, as you can see on the page 1 chart.

Question: All right, what do you think all that is telling us?

Answer: I think it is telling us that the overall trend of this market is down, and that it is going to stay down for quite a while. The resistance to decline evidenced in Transports could be saying that a short-term rally is nearing, but the best I see is maybe a rally back to or near the 800 level. Whether we get a short-term rally here or not makes **no difference** in my thinking. What I'm concerned with in this bear market is that my subscribers stay on top of the cliff, rather than going over it with the market. And that means a position of T-bills and gold.



Question: What about the weakness in Industrials, Utilities and Bonds as against Transport resistance. What do you make of that?

Answer: Within the context of this continuing primary bear market, I believe the weak Industrial Average is telling us that there is going to be a squeeze on corporate profits. I believe the sliding Utility and Bond Averages are telling us that we're facing a crush (already visible) in the money markets. Uncle Sam is coming in for money, money and more money (plus refinancing of existing debts), and he's going to get it. Uncle is going to get it because he's going to be high bidder (via rising interest rates).

Question:Lovely, Russell, and what do you see next? What about the Transports?

Answer: My guess is that in the months ahead we are going to see a slide in actual sales of goods. A turn to major weakness in the Transportation Average should signal that turn of events. Remember, the Transports (trucks, rails, airlines) carry the goods, and when sales drop off, so do the carrier profits. So far, I feel that the Transports as a group have simply been declining in sympathy with the vicious decline in the D-J Industrial Average. Let me put it this way: right now I think many sophisticated investors see the possibility of trouble on the corporate profits and money fronts. But almost no one is thinking in terms of an actual fall-off in the volume of sales. They just don't believe it can happen. But I think it can happen–and will.

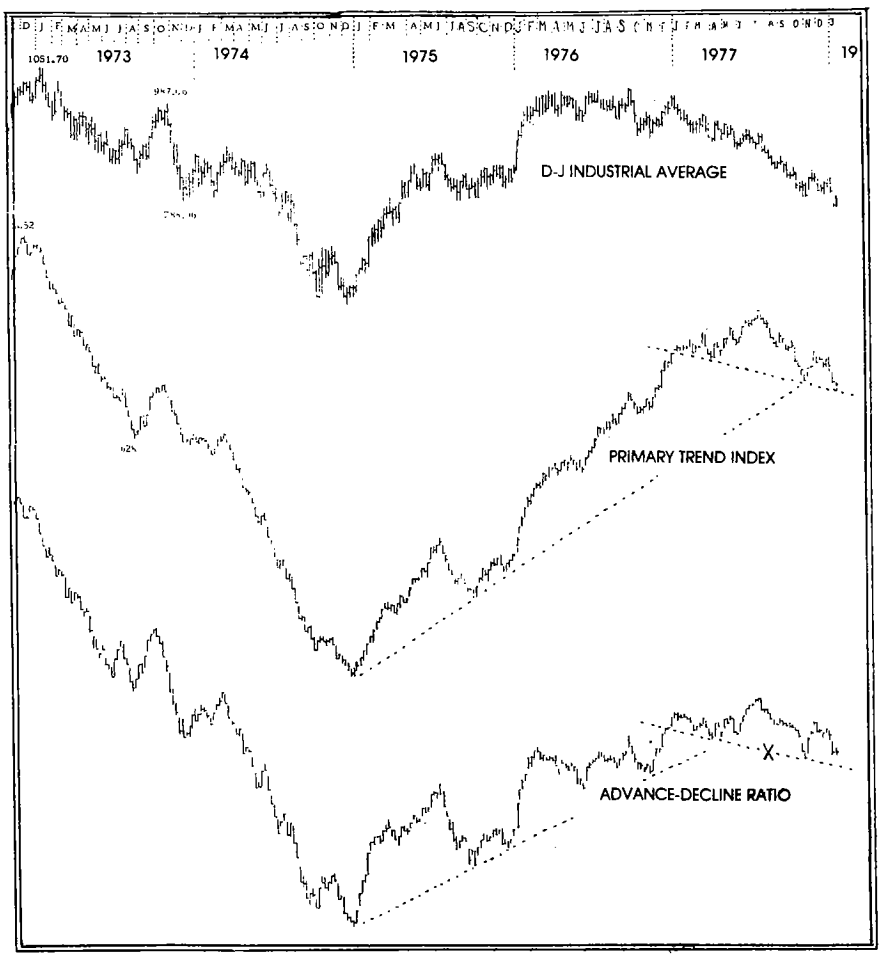
Question: How about the "rest of the market" as represented by the non-Dow stocks, the secondaries, the AMEX stocks, etc. What do you see for them?

Answer: I believe they are floating around on a sea of optimism and complacency. *I don't think that complacency is going to last*. When the complacency goes, the rest of the market will go.

Question: Russell, if you're bearish on this market, then why don't you come out with a list of short sales candidates? What's your objection to making money on the downside?

Answer: I have no objection. But I've noted over the yearsthat the great majority of subscribers lost money on their short sales. When you're short, you're not investing, you're speculating for the decline. You find yourself getting up in the morning and praying for bad news. You find you're afraid to turn the radio on because you might hear that the market rallied while you were out for lunch. That kind of psychology seems to go against most people's grain–and they just don't make money in shorts. Now I'll admit that there is a certain type of sophisticated subscriber who loves the short side and these fellows make money in their shorts. They know who they are, and they put out their shorts when their own bearishness jibes with mine. I'm not talking for their benefit, I'm talking for my average subscriber who is not at home waiting for a market collapse.

And remember this, when you are in cash (T-bills) and gold, you're short in a sense. You are short to the extent that in terms of stocks, your **purchasing power is rising**. The subscriber who is in cash can now buy 12% more of AT&T per dollar than he could last year or 25% more of GM or 51% more of Kodak. If he bought gold a few weeks ago at 157 he is now ahead by about 11%. Meanwhile he is earning over 6% on his T-bills. So let's not get carried away, and let's not get greedy. Our next major move should be back into the stock market, but without the proper **timing**, we might as well try winning at Santa Anita riding a Mexican burro.



Question: Has there been any major technical developments since the last report?

Answer: The most interesting development to my mind has been the ominous tops which have formed in the Primary Trend Index and the Advance-Decline Ratio as shown on the accompanying weekly chart. The Primary Trend Index (PTI) is an index which I developed about 6 years ago, an index which I felt could not be "fooled" by any particular aberration or maladjustment during a given time period. The reason it would not be fooled is that the PTI is an amalgam of 8 very important indicators, including 4 stock averages, a bond average, high-lows, advance-declines, and the most actives. So the PTI is really a "weight of evidence" indicator.

As you can see on this weekly chart, the PTI has fomed a huge "head-and-shoulders" top, and as of last week the PTI has sunk to its lowest level since late-1976. The broad rising trend which has been in force since December, 1974 has been reversed, and the PTI is telling us that the technical indicators are heading down with a vengeance.

The A-D ratio has broken its 1974-77 rising trendline, but the late-1977 low has not quite been violated–yet. But as you can see, the top has been formed. If or when the trendline (marked "X" on chart) is broken, we should see the beginning of the great collapse in secondary shares.

Another most interesting picture is my chart of the over-bought and over-sold indicators (I just don't have enough space for everything, but refer to Letter 718, page 2 for this chart). Ten days ago the "market-trend indicator" got down to minus 1270, but this was not the minus 1400 or more I need for an over-sold. The "most-actives index" got down to minus 53, which is over-sold but I need **both** of these indicators in over-sold territory for a valid reading. Then last week the market rallied and the indicators again moved away from the over-sold area.

Thus, it has been 15 months since these two indicators have flashed a full over-sold signal for the market. The persistent, stubborn, overriding COMPLACENCY since October, 1976 has prevented an over-sold signal from occurring, despite the fact that I have had three over-bought signals on these indicators since that time. Each over-bought signal finds the Dow at a lower level. The LONGER the time elapsed and the more over-bought signals we receive prior to an ultimate over-sold, the bigger the downside slide that can be expected when this market finally goes to an over-sold condition.

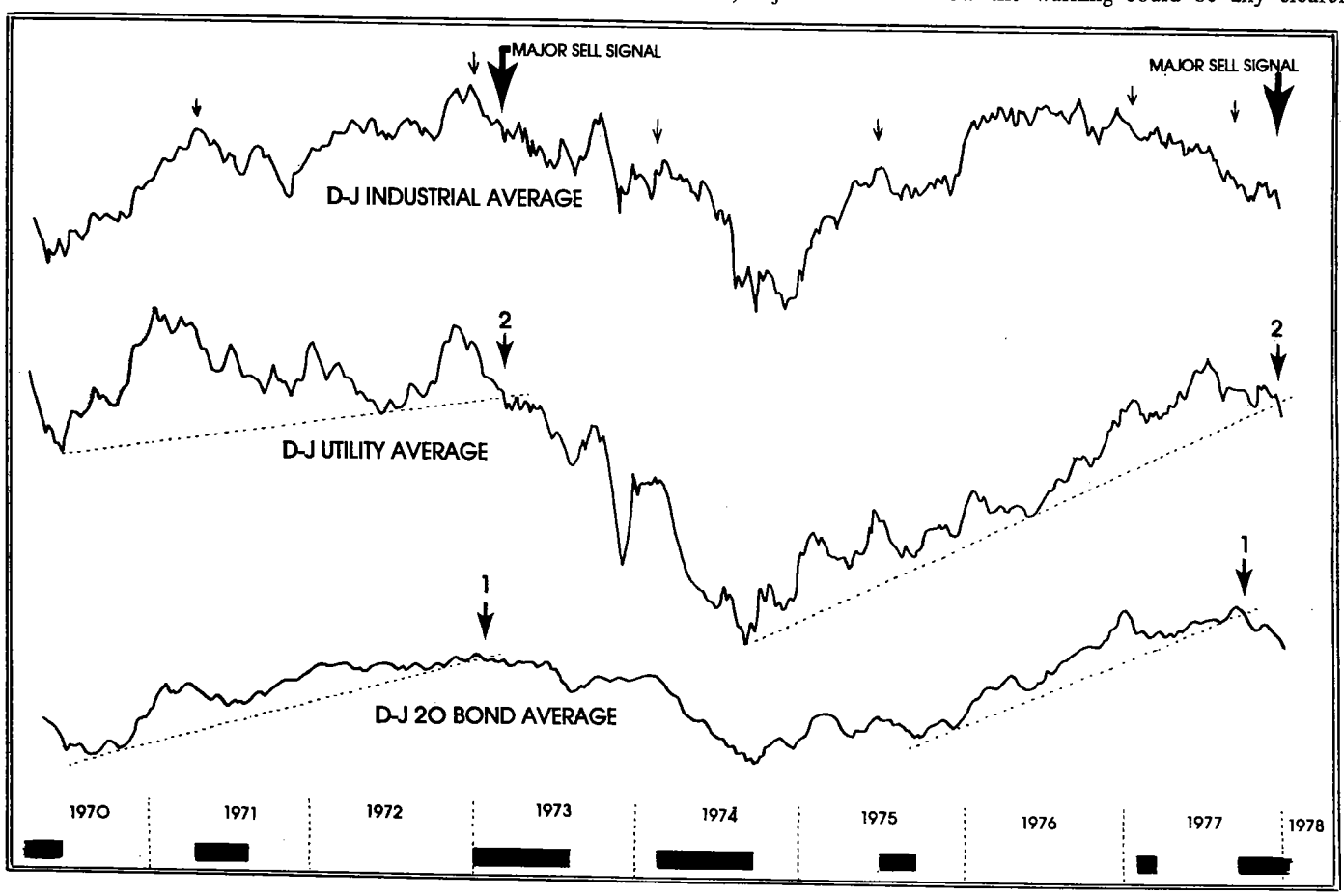
RUSSELL'S UTILITY-BOND RULE: This is really a case of where the chart tells the whole story, but I'll add a bit anyway. Subscribers who have been with me for a decade or more should now be thoroughly familiar with a "rule" which I developed in the early 1960's. The rule runs this way: "Whenever the D-J 20-Bond Average and the D-J Utility Average are BOTH in established bullish trends, the background conditions for the market are positive and stocks will advance. Conversely, whenever the trend of BOTH Bonds and Utilities is down, the market background is negative and stocks will decline."

I have included a section of my chart of the Dow Industrials together with the Utility and Bond Averages, with all three going back to 1970. The black horizontal bars at the bottom of the chart identify periods in which **both** Bonds and Utilities were declining. The **small** down-arrow above the Dow identifies the beginning of each period of joint Bond-Utility decline. Note that the Dow invariably declined (down-arrows) during each of the "black-bar" periods.

There is a further and much more bearish signal that can be given under this study. This is the signal which is set off when Bonds and Utilities not only are declining, but WHEN THE DECLINES RESULT IN A BREAKING OF MAJOR TRENDLINES. Going back to 1966, there have been **only two** such signals. The first occurred in early-1973, when first the Bond Average and then the Utility Average broke below long ascending trendlines. I have marked those breaks with two arrows. Arrow No. 1 identifies the Bond Average's rupturing of a three-year trendline, Arrow No. 2 identifies the Utility Average's breaking of a similar three-year rising trendline. The aftermath was one of the worst market smashes on record, the cave-in of 1973-74.

Over the past few weeks we have received the second instance of this type of major Bond-Utility bear signal. Note on the chart that the D-J 20-Bond Average violated a three-year rising trendline in late-1977 (down arrow no. 1). Then a few weeks ago the Utility Average confirmed by cracking a three-and one-half year trendline of its own (down-arrow no. 2 on chart).

Thus, on this study the Utilities and Bonds have now given their most bearish signal since early-1973. I take this as a warning, loud and clear, for the rest of the stock market. As a matter of fact, I just don't see how the warning could be any clearer.

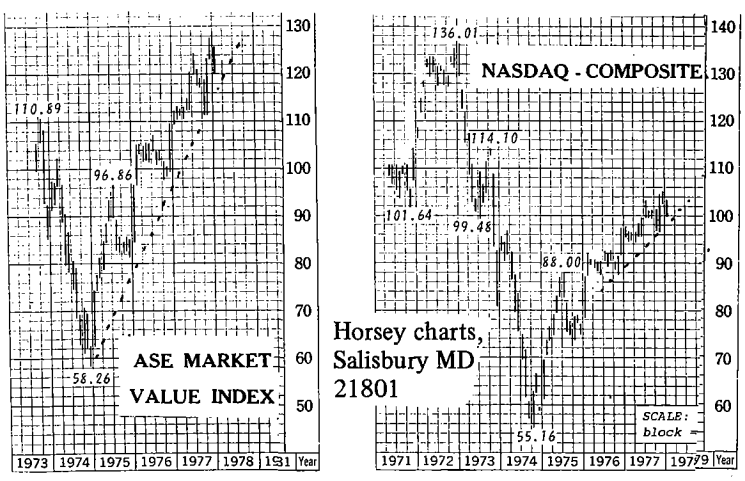


HO-HUM: To my mind, the outstanding single factor pertaining to the current market is contained in the word COMPLACENCY. In the face of the 16-month decline in the blue-chip D-J Industrials Average, I take this complacency to represent an ominous and bearish phenomenon for the stock market.

Why do I make that statement? Because the market at any given time possesses a bullish or bearish "potential." A bull market has a certain potential (or target) on the upside; a bear market possesses a certain target on the downside. We are now in a bear market, and there is bearish potential "down below" towards which the market is heading. In other words, there is a certain downside level which, when reached, will express all the bearish possibilities. That "bearish potential," when reached, will have discounted the worst of the dollar problem, the worst of the trade deficit problem, the Federal budget deficit problem, the corporate profits problem, the bank foreign loan problems, inflation, the whole works.

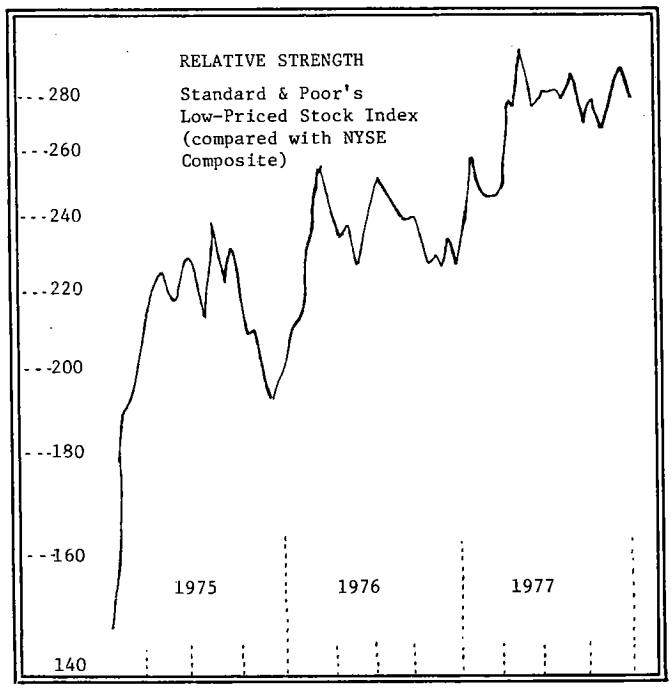
The next question: how do we know when we are "there," there at the point where the market has discounted the final bearish potential? One way we will know is by studying investor and public **sentiment**. Sentiment at the bottom should be pessimistic, gloomy, with a general feeling of hopelessness. When the bearish sentiment is so thick you can "cut it with a knife," when the leading sages of the day are telling us that "the market can only go lower," at that point we can infer that the worst has been discounted. At that point we can guess that the full bearish potential has been reached.

Now if we keep that background concept in mind, what do we see today? (1) In December, 1977, margin debt on the NYSE jumped $130 million to $9.5 billion, near the all-time record high for margin debt. When people are up to their ears in margin, then let's face it, they are evidencing optimism, not pessimism. (2) Despite the 24% drop in the Dow since September, 1976, the rather speculative AMEX and NASDAQ indices have been pulling in a good deal of new money. This is obvious from a study of the accompanying monthly chart, which shows that neither of these two "junior" indices have yet broken down (although they are getting mighty close).



Horsey charts,
Salisbury MD
21801

(3) The relative strength (RS) of the "cats-and-dogs" as represented by the S&P Low-Priced Stock Index is still far outperforming the general market, as you can see on the next chart. This is hardly a manifestation of investor pessimism or gloom. (4) Odd-lot short sales have held at extremely low levels during 1977 and 1978. Thus, the very speculative-minded



odd-lot short seller, despite the crumbling Dow, has refused to believe that he can make money on the downside (which is another outstanding sign of complacency). (5) I could go on and on, but I do want to mention that despite the Dow Theory bear signal, despite the smash in the dollar, despite the Dow drop, despite the big drop in bonds, the great majority of economists and economic commentators hold firmly to the view that "1978 will be a good year, not great but good." Frankly, I've never seen economists so complacent in the face of many warning signals from Wall Street.

My conclusion is obvious. The market's downside potential has not been met. My guess is that during the several months ahead we should see a major slide in the market, with perhaps a frightening collapse of the non-Dow stocks (i.e., those stocks which have held up so valiantly while GM, DuPont, MMM and Union Carbide have been sliding to successive new lows).

NEW PAGES: As most subscribers know, I publish two loose-leaf chart albums. One contains the daily history of the D-J Averages (one year per page) going back to 1885. This album contains the daily prices of the D-J Industrials, Transports, Utilities plus the daily D-J Bond Average and daily NYSE volume. It is the only daily history of its kind in existence (historical events are also noted), and I find it invaluable in my own studies. Price is $49 ($52 for Californians). The new 1977 page is now available at a price of $2.

I also publish the daily Dow Industrials and (daily) Advance-Decline ratio in a second album, one page for each year going back to May, 1930. I use this album almost daily in my studies of the market, and I offer the album to subscribers at a price of $35 ($37.10 for Californians). The new 1977 page is now available for the A-D album at a price of $2.

Important: I must have your order immediately, as I will only print to cover orders received. I have sold many hundreds of these beautiful albums, but I still have to know who wants the new pages. (The albums, by the way, have fine-looking hard-cover three-ringed binders). Personally, I cannot imagine any trader, investor or serious market student being without them. Once I am sold out, I will probably never republish them again.

NOTES & QUOTES: Those who believe that the Carter Administration is going to be a "guardian of the dollar" are sadly mistaken. The budget deficits are fated to grow. A $500 billion Federal budget is slated for fiscal year 1979. The 1979 Federal expenditures will thus be 24% higher than the 1977 expenditures, and they will also be a larger percentage of the GNP than in any year since the Korean War (1950) to 1975. As a matter of fact, the 1979 Carter expenditures will be a whopping $30 billion higher than the projected spending that was contained in President Ford's "game-plan." Put it this way, with a $25 billion tax cut slated for this year, the fiscal year 1979 Federal Budget deficit will be the same (or larger) than the $60 billion deficit that will show for this year (see Letter 718, page 5 for historical deficit comparisons).

* *

The next world trouble area could well be this one: according to former New York Times Washington Bureau chief James Reston, the Soviet is now moving to dominate or control Mid-East oil sources. Russia is reported to be building up their military power in Aden, in South Yemen on the Gulf of Aden, near the entrance to the Red Sea. The Cubans and Russians are also fighting with the Etheopians to capture the coastline of Somalia on the Indian Ocean. If they do this, they will dominate the Red Sea coast of Saudi Arabia, and will be able to put huge pressure on the Saudis, and the Saudis in turn are the chief financial support for Egypt. What is the reason for all this? Best estimates are that Russia is going to need outside oil by 1985-87. And they are moving now, to secure control of those needed oil resources. Knowledge of this is probably the reason why the Carter Administration (despite earlier mouthings) has boosted next year's military spending from $116 billion to $126 billion.

* *

Today's big banks don't go where the safety is, they go where the profits (or should I say potential profits) are. But what profitith a bank if it gains the world but loses its capital? The "less-developed-countries" owe a collective $160 billion to private sources, and half of it is due for repayment in the next two years. Already a lengthening list of countries such as Turkey, Zaire, Zambia, Peru, Jamaica and Indonesia have said, "Either re-schedule or we default."

	1976	
	International earnings $m	% of total earnings
BankAmerica	134.4	40
Citicorp	293.0	72
Chase Manhattan	82.0	78
Manufacturers Hanover	80.2	56
J. P. Morgan	107.4	53
Bankers Trust New York	36.9	64
Chemical New York	41.0	44
First Chicago	15.8	17
Continental Illinois	30.0	23
Charter New York (Irving Trust)	24.7	58
First National Boston	27.9	65
Wells Fargo	7.6	12
Security Pacific	5.3	7

Estimated. Source: Salomon Bros

The fact is that the banks are locked into these loans, and the banks are never going to collect on a good part of these loans. "Why," you ask, "Why did the banks do it?" And the answer is simple, because that's where the "profits" were. Examine this listing of major US banks and you'll note that a huge portion of the banks' earnings come from overseas sources. Isn't that exciting! And if they never get their capital back, well it was a hell of an idea anyway. And I guess this explains why some of the big banks have been making the new low lists in 1977 and '78. One more comment on my part: if the world goes into recession in 1978 you can kiss an even larger chunk of these loans goodbye. And that's it for the banks and the banks' earnings, readers.

GOLD: According to *Green's Commodity Comments* (PO Box 174, Princeton, NJ 08540) the year 1976 saw a total gold *supply* of 46.5 million ounces, and this included IMF and Russian sales, plus central bank sales and new production. The year 1977 saw supply increase to 53 million ounces. But though supply increased 13% in 1977, it is obvious that the supply was gobbled up at higher prices. My own guess is that total supply will drop in 1978. I believe central banks will pull in their selling (and probably turn to net buying) while Russian sales could also contract. With a whopping increase in world monetary inflation (a polite phrase for the wholesale printing of paper money) slated for 1978, my guess is that more paper is going to chase gold than ever before. When it takes more paper to buy gold, then the paper price of gold goes up. And that is exactly what we have been seeing as gold vaults the 175 level here in the opening months of 1978.

Anyone who examines the developing picture has to be just a bit frightened. Here we have an inept American President who wants bigger and better deficits (that's what tax cuts produce), we have an amateur Fed Chairman dedicated to a "growth-oriented policy" (according to *Business Week* - Jan. 30), we have an economy that is dragging its feet, we have a debt picture which is being financed and re-financed at higher and higher interest rates–and the net result is that the lake of US debt turns into a great lake, and the great lake turns into an ocean, and the ocean now threatens to inundate what is left of the land.

"When the debt grows, gold glows." What we are seeing now is what I've been warning about for many months (actually years). It's debt running "out of control." Indeed, the actual interest on the debts is running out of control, and this threatens (1) a wild run-up in interest rates, (2) an initial slump in business, (3) new rounds of pump-priming and inflation to combat slumping business, (4) fearful recognition that the new re-inflation isn't really doing that much for business, so (5) the final stages of the slump will set off deflation, liquidation of debt and bankruptcies.

But let's take one thing at a time. Right now we're seeing gold go up in response to fear on the part of the US and the world, fear of a new round of staggering US deficits. The US is now being forced to choose between inflation and politically unpalatable stag-flation and unemployment. With the exit of Mr. Burns, it became obvious that the US has chosen to let inflation run. Gold is the barometer, and the barometer is heading up.

How high will it go, you ask? I don't know, for the simple reason that we're dealing with forces of unknown power. We're dealing with tens of billions of dollars round the world, any part of which may opt for gold. We're dealing with men's fears, and fears are not measurable. Therefore, I turn to my charts and technical studies, and I try to fathom the unfathomable.

First, turn to the chart of gold and its 13-week momentum. The momentum is actually a rate of change, based on the price of gold each week (Thursday second fix) as a ratio of its price 13 weeks ago. The arrows denote reversals in momentum.

Note that momentum rocketed up to 173 in February, 1974, five weeks before gold hit its first peak. Momentum turned up again in mid-1974, topping out at a level of 133 in December, and breaking its trendline in January, 1975. Both down arrows provided excellent "exit signals" for gold holders.

Gold momentum was rather indecisive during most of 1976. During late-1976 and early 1977 a triangle formed in momentum, bordered by the converging trendlines A and B on the chart. When gold momentum broke upside in October, 1977, I said "let's get in," and this has been my position ever since.

As of last week momentum was walking bullishly above trendline B, but the walk has been a shallow one. The latest reading for gold momentum is 113, below even the December, 1976 reading of 123. If and when momentum pushes above 123 I would guess that the whole gold advance will start "catching fire."

We now have rising momentum line B under gold. I expect a steeper momentum trendline to appear before long. Usually a momentum line will reverse to the downside **before** price. When that finally happens, I will probably recommend cutting down gold positions or moving out of the metal. But so far, gold momentum is telling us that the rise has not reached anything like the speculative stage. A momentum figure of 130 or more will indicate to me that gold is becoming a speculative item. Meanwhile, the higher the metal price can rise with momentum holding low (as now), the higher the final price for gold prior to a top-out.

One comment of interest: Gold has reached a price of 177 with momentum at only 113. This suggests to me that gold is going **higher** on this move than most people foresee. I note also that most of the veteran gold-bugs are very conservative these days, talking about "185 or 200 for gold in 1978." My guess (and this is obviously only a guess) is that gold is going to go above 250 in 1978, maybe well above that figure. The way the momentum line is creeping so gradually upward suggests a high 1978 figure for gold.

My point and figure chart of gold shows a massive pattern, most of which could be a base of accumulation. I have seldom seen a "head-and-shoulders" base of this size and symmetry. The chart portrays gold chewing relentlessly through the 160-175 supply area. Gold could now move to 185, then back off and consolidate, thus retaining the symmetry of the overall pattern. In fact, this would be the most bullish action possible for gold. Or gold could drop back to test the area of its 4-week moving average (which now stands at about 170). In either event, the gold price action would be excellent.

WIND-UP: For the benefit of new subscribers, I will repeat again that I would like you to be 80% to 85% in Treasury bills with the remainder in gold coins or bullion. As for the market, my advance-decline now shows only 8 plusses out of 21 trading sessions, which means the market could be in for some even-ing up. Thus, a little rally could materialize, aided by the Transport non-confirmation. But I believe the Industrials, Utilities and Bonds are telling a bearish story with the A-D and the rest of the market ready to deteriorate badly. Skip any rallies, let's play it safe.

NEXT MAILING: February 8th